No. 22,070

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

FRED W. ALKIRE AND LOIS O. ALKIRE,

Appellants

v.

ROBERT A. RIDDELL,

Appellee

ON APPEAL FROM
THE JUDGMENT OF THE UNITED STATES DISTRICT COURT
FOR THE CENTRAL DISTRICT OF CALIFORNIA

BRIEF FOR THE APPELLEE

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Assistant Attorney General,

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OPINION BELOW

The Amended Findings of Fact and Conclusions of Law of the District Court for the Central District of California (I-R. 129-136) are not officially reported.

JURISDICTION

This appeal involves federal income taxes for the calendar years 1959, 1960, 1961, and 1962. The taxes in dispute were paid on June 16, 1964. (I-R. 131.) Claims for refund were timely filed on August 18, 1964, and on January 15, 1965, the taxpayers filed with the District Director a waiver of statutory notice of disallowance of the claims. (I-R. 131.) Within the time provided in

Section 6532 of the Internal Revenue Code of 1954, on June 21, 1965, the taxpayers brought this action in the District Court for recovery of the taxes paid. (I-R. 2-4.) Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1340. The judgment of the District Court was entered on March 20, 1967. (I-R. 93.) On March 28, 1967, a motion for amendment of findings, for additional findings and for special findings was filed. (I-R. 100-101.) This motion was denied in an order filed April 18, 1967. (I-R. 137-138.) Taxpayers' notice of appeal was filed on June 14, 1967. (I-R. 139.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTIONS PRESENTED

1. Whether the District Court correctly ruled that the royalty payments received by the taxpayer, 1/ based on quantities of sand, gravel, and allied materials extracted, were ordinary income subject to the depletion allowance, not capital gain from a sale as taxpayer contends.

2. Whether, if the payments were capital proceeds, they were taxable as short-term or long-term capital gain.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

SEC. 61. GROSS INCOME DEFINED.

(a) General Definition.--Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

1/ Taxpayer Fred W. Alkire is referred to herein as "the taxpayer" since Lois O. Alkire, his wife, is a party to this action solely by reason of the joint returns filed.

*   *   *   *

(6) Royalties;

*   *   *   *

(26 U.S.C. 1964 ed., Sec. 61.)

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) General Rule.--In the case of mines, oil and gas wells, other natural deposits, * * * there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion * * *, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. * * *

*   *   *   *

(26 U.S.C. 1964 ed., Sec. 611.)

SEC. 613. PERCENTAGE DEPLETION.

(a) General Rule.--In the case of mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property * * *. * * *

(b) Percentage Depletion Rates.-- The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

*   *   *   *

(5) 5 percent--

(A) * * * gravel * * * and stone * * *; * * *

*   *   *   *

(26 U.S.C. 1964 ed., Sec. 613.)

SEC. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

For purposes of this subtitle--

(1) Short-term capital gain.--The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent such gain is taken

into account in computing gross income.

* * * *

(26 U.S.C. 1964 ed., Sec. 1222.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.611-1 Allowance of deduction for depletion.

* * * *

(b) Economic interest. (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. * * *

* * * *

(26 C.F.R., Sec. 1.611-1.)

STATEMENT

The material facts, as found by the District Court (I-R. 130-135), may be summarized as follows:

On December 7, 1954, taxpayer as lessee and the Irvine Company as lessor executed a lease giving taxpayer the exclusive right to extract, process, and remove from the leased premises sand, gravel, and allied materials suitable for highway construction during the period beginning December 15, 1954, and ending December 14, 1969. Taxpayer took possession of the leased premises on December 7, 1954, and began operations on December 15, 1954. (I-R. 133.)

On June 17, 1955, the lease of December 7, 1954, was

canceled and a new lease, dated June 1, 1955, was executed by the Irvine Company as lessor and the taxpayer and E. O. Rodeffer as co-lessees. The new lease conferred the same rights as the old, for the period beginning June 1, 1955, and ending May 31, 1970. (I-R. 133-134.) Neither lease obligated the lessees to extract materials from the leased premises. (I-R. 135.)

On July 9, 1955, taxpayer and Rodeffer executed an "Assignment", dated June 1, 1955, assigning their leasehold interests to Star Rock Products, a corporation wholly owned by Rodeffer which extracted, processed, and sold rock, sand, and gravel. Star Rock Products accepted the assignment by an "Acceptance" dated June 1, 1955, and executed by the corporation's authorized officers on July 11, 1955. The Irvine Company consented to the assignment in a "Consent" dated June 1, 1955, and executed by Irvine's authorized officers on or about July 11, 1955. Star Rock Products took possession of the leasehold premises on or after July 1, 1955. (I-R. 134.)

Taxpayer retained his leasehold interest under the lease of June 1, 1955, for a period of less than six months. (I-R. 134.)

Under Provision 7(a) of an agreement between taxpayer and Rodeffer, dated May 27, 1955, it was required that (I-R. 132):

> Fred Alkire shall receive and Star Rock Products shall pay to him a royalty of 3¢ per ton on each and every ton of material produced from said leasehold and sold by Star Rock Products, or its successor, hereafter. Said royalty shall be paid monthly on the 15th day of each and every month during the term of this agreement.

Provision 8 declared that (I-R. 132-133):

> This agreement shall remain in full force and effect so long as operations are conducted upon the leasehold and rock is

produced therefrom by Star Rock Products, its successor or successors.

On September 1, 1960, Star Rock Products and eight other corporations, also wholly owned by Rodeffer, were merged in Rodeffer Industries, Inc., which continued to extract, process, and sell rock, sand, and gravel. (I-R. 131.) For the calendar years 1959, 1960, 1961, and 1962, Star Rock Products and its successor, Rodeffer Industries, Inc., paid to taxpayer, pursuant to Provision 7(a) of the agreement of May 27, 1955, between taxpayer and Rodeffer, the following amounts (I-R. 132):

1959	$ 29,151.58
1960	37,277.16
1961	34,867.60
1962	30,755.19
	$132,051.53

These payments were based solely upon the quantities of materials extracted, produced, and sold by Star Rock Products and Rodeffer Industries, Inc., from the leased premises covered by the lease dated June 1, 1955. (I-R. 135.)

In their joint returns taxpayers reported the payments as long-term capital gain. (I-R. 132.) The District Director determined that the payments were ordinary income, subject to the depletion allowance, and assessed deficiencies and interest accordingly. (I-R. 130-131.) After taxpayers paid the assessments and filed timely claims for refund, this litigation followed. (I-R. 131.)

SUMMARY OF ARGUMENT

Taxpayer transferred to an operating company his right to exploit deposits of sand, gravel and allied materials, in consideration of royalties based on quantities of materials produced. The operating company was not obligated to mine or pay for any particular amount of materials, but only to pay three cents per ton, when and as extracted, produced and sold. The District Court was clearly correct in ruling that the payments were depletable ordinary income to taxpayer, not capital gain from a sale as taxpayer contends.

In its decisions evolving the "economic interest" concept, the Supreme Court established the rule that the owner of a depletable capital interest in minerals in place retains that interest so long as he continues to look solely to income derived from extraction for a return of his capital, and that his continuing share of production income is depletable ordinary income -- not capital gain from a sale. It is clear from the Court's decisions that the rule applies without regard to the kind of mineral or the form of royalty involved.

Five Courts of Appeals have applied that rule to the type of transaction here involved. Their decisions squarely support the decision of the District Court in the instant case.

We submit that the instant decision is correct and should be affirmed.

ARGUMENT

I

THE DISTRICT COURT CORRECTLY RULED THAT THE ROYALTY PAYMENTS RECEIVED BY TAXPAYER WERE ORDINARY INCOME SUBJECT TO THE DEPLETION ALLOWANCE.

A. Introduction

The major issue in this case is whether the per ton royalty payments received by taxpayer were the capital proceeds of a sale, as taxpayer contends, or ordinary income subject to the depletion allowance, as the District Court held.

The form of the transaction involved is undisputed. Taxpayer and Rodeffer, as co-lessees, had the right to mine the Irvine Company's deposits of sand, gravel and allied materials for a 15-year period. The co-lessees were not obligated to remove any particular amount of materials. They transferred their operating rights to Star Rock Products. The sole consideration to taxpayer for this transfer was a royalty of three cents per ton of materials extracted, produced and sold.

Taxpayer contends (Br. 8 et seq.) that this was a capital transaction under criteria which are specifically applicable to hard minerals -- criteria which differ from those governing oil and gas transactions. But the asserted dichotomy in criteria is refuted by relevant decisions of the Supreme Court, as recognized in recent decisions of five Courts of Appeals. Under those cases, a transfer of mineral operating rights in consideration of payments dependent upon production is not a sale but a leasing or licensing arrangement

which yields depletable ordinary income -- whatever the kind of mineral and the form of royalty involved.

B. The controlling principles

Section 611(a) of the Internal Revenue Code of 1954, supra, allows as a deduction in computing taxable income, in the case of mines and other natural deposits, "a reasonable allowance for depletion * * * according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate". In the case of sand and gravel and allied materials, a percentage depletion deduction in the amount of five per cent of the gross income from the property was authorized by the statutory provision (Section 613(b)(5)(A), supra), applicable to the taxable years involved.

The depletion allowance "is based on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit", and "is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired". Commissioner v. Southwest Expl. Co., 350 U.S. 308, 312. Accord, Anderson v. Helvering, 310 U.S. 404, 407-408; Parsons v. Smith, 359 U.S. 215, 220; United States v. Cannelton Sewer Pipe Co., 364 U.S. 76, 81; Paragon Coal Co. v. Commissioner, 380 U.S. 624, 626.

So long as the owner of a capital interest in minerals in place retains such interest, the depletion deduction is the only permissible way in which he may be compensated for the disposition,

through production, of his capital asset. He is not entitled to capital gain treatment of production income, whether he operates the property himself or, as lessor, receives a share of the production income in the form of royalties. This was settled at an early date in Burnet v. Harmel, 287 U.S. 103. There the Supreme Court considered the contention of a lessor of an oil and gas property that a lease bonus and royalties received under the lease were taxable as capital gain. Rejecting the contention, the Court held that taxing the bonus and royalties as ordinary income did not produce the hardship at which the capital gains provisions were directed, i.e., the realization and taxation in one year of a total appreciation in value which had taken place over a considerable period of time. The Court regarded it as immaterial for federal tax purposes that the lease, under local law, effected a transfer of title.

A month after Burnet v. Harmel was decided, the Supreme Court took the same view as to hard minerals in Bankers Coal Co. v. Burnet, 287 U.S. 308. There the taxpayer-lessor had transferred operating rights in coal deposits in consideration of a per ton royalty with an annual minimum royalty guaranteed. The taxpayer contended that the royalties were capital gain from a sale. The Court again rejected this view of royalties paid under a mineral lease and, relying upon Burnet v. Harmel, supra, said (287 U.S. at p. 311):

> The considerations which led to the conclusion that the bonus and royalties paid to the lessor of Texas oil lands are taxable income and not a conversion of capital, as upon a sale of capital assets, are equally applicable to West Virginia coal leases,

whether the title to the coal in place passes to the lessee at the date of the lease, or only upon severance by the lessee.

Shortly after deciding Bankers Coal Co., the Supreme Court enunciated the "economic interest" concept for the first time in Palmer v. Bender, 287 U.S. 551. This concept, fully consonant with the earlier decisions, embodied specific tests for determining whether, in a mineral transaction, a taxpayer has acquired or retained a depletable interest in minerals in place. The Court defined an "economic interest" (287 U.S. at p. 557) in terms of two requirements which are set forth in the current Treasury Regulations on Income Tax (1954 Code), Section 1.611-1(b)(1), supra, as follows:

> An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place * * * and secures, by any form of legal relationship, income derived from the extraction of the mineral * * *, to which he must look for a return of his capital.

Under these requirements it may be noted, first, that a taxpayer need not have fee title to a mineral property in order to have a depletable economic interest; it suffices if he has acquired by investment any interest in mineral in place. Secondly, it is immaterial whether the taxpayer has or retains the operating rights. Hence, a transfer of operating rights, without more, does not divest a taxpayer of his depletable economic interest. He retains that interest if he continues to "look solely to the extraction" of the mineral for a return of his capital. Commissioner v. Southwest Expl. Co., supra, p. 314.

In Palmer v. Bender the taxpayers, who owned oil and gas leasehold interests, transferred the operating rights for bonuses, royalties and production payments. The Court held, as it had in Burnet v. Harmel and Bankers Coal Co., that the considerations for the transfer were depletable ordinary income, not capital gain from a sale as the taxpayers contended.

Transactions which do and do not constitute sales have been contrasted by the Supreme Court in Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25, 35-36, as follows:

> * * * there must be a determination under federal tax law as to "whether the transferor has made an absolute sale or has retained" such economic interest as we have just described in the preceding paragraph. * * * We have said that the instrument should be construed as a sale when a large cash payment was made with a reserved payment that could be satisfied by future sales of the transferred property without extraction of the oil. Obviously, there could be no depletion without extraction. Anderson v. Helvering, 310 U.S. 404, 412. On the other hand, we have construed an assignment of oil leases for cash and a deferred payment, "payable out of oil only, if, as and when produced," as the reservation of an economic interest * * * -- not a sale. Thomas v. Perkins, 301 U.S. 655.

Over the years, the Supreme Court has recognized that the requisite continuing dependence on extraction may take a variety of forms. Thus, it has recognized that an economic interest is retained where the payments are in cash rather than in kind, Helvering v. Twin Bell Syndicate, 293 U.S. 312; or constitute a percentage of gross production, Burnet v. Harmel, supra; or a percentage of the net profits, Burton-Sutton Oil Co. v. Commissioner, supra. And payment is deemed no less dependent upon extraction because

the transferor receives an initial lump sum payment (or "bonus") in addition to the right to future royalties. Burnet v. Harmel, supra; Thomas v. Perkins, 301 U.S. 655.

Similarly, royalties in a fixed amount per unit of minerals removed are depletable ordinary income, not capital gain, to a transferor of operating rights. Bankers Coal Co. v. Burnet, supra. Twelve years after that decision, in Douglas v. Commissioner, 322 U.S. 275, the Supreme Court again dealt with a transfer of operating rights in hard minerals in consideration of a fixed royalty per ton with an annual minimum payment guaranteed. While the precise issue was the validity of Treasury Regulations requiring restoration of depletion deductions to basis in the absence of production, the Court recognized that the royalty payments clearly were depletable ordinary income to the transferor in the first instance.

In accord with the Supreme Court's decisions, five Courts of Appeals have recently held in cases involving hard minerals (usually sand and gravel) that royalties in a fixed amount per unit of minerals removed were not capital gain from a sale but depletable ordinary income to the taxpayers, who had transferred the operating rights in consideration of such royalties. Royalton Stone Corp. v. Commissioner, 379 F.2d 298 (C.A. 2d), certiorari denied December 4, 1967 (36 U.S. Law Week 3227); Wood v. United States, 377 F.2d 300 (C.A. 5th), certiorari denied December 4, 1967 (36 U.S. Law Week 3227); United States v. Peeler, 377 F.2d 531 (C.A. 5th), certiorari denied December 4, 1967 (36 U.S. Law Week 3227); United States v. Green, 377 F.2d 550 (C.A. 5th), certiorari denied

December 4, 1967 (36 U.S. Law Week 3227); Schreiber v. United States (C.A. 7th), decided July 17, 1960 (20 A.F.T.R. 2d 5126); Freund v. United States, 367 F.2d 776 (C.A. 7th); Rabiner v. Bacon, 373 F.2d 537 (C.A. 8th); Laudenslager v. Commissioner, 305 F.2d 686 (C.A. 3d), certiorari denied, 371 U.S. 947.

There is one appellate decision, Linehan v. Commissioner, 297 F.2d 276 (C.A. 1st), which cannot be squared with the above-cited Supreme Court and appellate decisions. In Linehan the court held that a transfer of operating rights in hard minerals for royalty payments measured by quantity was a sale, reasoning that (p. 279) --

> the taxpayer had no "economic interest" in the material taken from his property after the severance, for in every instance he sold sand and gravel for fixed prices per cubic yard without reference to the prices received or the profits, if any, made by the exploiters.

This rationale is in direct conflict with the Supreme Court's decision in Bankers Coal Co. v. Burnet, supra. It has not been adopted by any other appellate court. To the contrary, it has been rejected by the Fifth Circuit in Wood, the Third Circuit in Laudenslager and the Eighth Circuit in Rabiner. And the Second Circuit ignored it in Royalton Stone, albeit the taxpayers in that case expressly relied upon Linehan.

The First Circuit's view that a taxpayer transfers his depletable interest in a capital transaction unless he retains his interest in the minerals "after severance", and shares in the proceeds or profits from the sale of the minerals, is clearly at odds with the Supreme Court's formulation and application of the

"economic interest" concept. The test is whether the transferor has retained an "economic interest" in minerals in place. Palmer v. Bender, supra. And there is no requirement that the transferor share in the proceeds or profits from mineral sales; it is enough if the transferor "secures, by any form of legal relationship, income derived from the extraction of the mineral * * *, to which he must look for a return of his capital". (Emphasis supplied.) Treasury Regulations, Section 1.611-1(b)(1), supra; Palmer v. Bender, supra, p. 557. As the Supreme Court reiterated in the more recent decision in Commissioner v. Southwest Expl. Co., supra, p. 314: "The second factor has been interpreted to mean that the taxpayer must look solely to the extraction of oil or gas for a return of his capital, * * *."

The First Circuit invoked Kirby Petroleum Co. v. Commissioner, 326 U.S. 599, but that case did not purport to modify or extend the "economic interest" concept. The transferor in Kirby Petroleum did indeed share in the profits of the transferee, through a retained net profits interest; and the Court held that a transferor retains his "economic interest" through retention of a net profits interest as well as through reservation of other forms of royalties. But the Court did not hold that the transferor must share in post-severance profits. Rather, the Court held (326 U.S. at p. 603):

> The test of the right to depletion is whether the taxpayer has a capital investment in the oil in place which is necessarily reduced as the oil is extracted. See Anderson v. Helvering, 310 U.S. 404, 407. [Emphasis supplied.]

Linehan was an unusual case on its facts. It involved an

agreement to excavate a tract of raised elevation down to a specified grade, in preparation for industrial use of the property as so graded, and there is some indication that the First Circuit viewed the transaction as the completed sale of a specific total quantity of minerals. In any event, the rationale of the case is simply wrong.

C. Taxpayer retained his "economic interest" in the minerals in place and received the royalty payments as depletable ordinary income, not capital gain

The Supreme Court's "economic interest" concept, as the very term indicates, relates to the substance of a transaction and not the legal forms employed. Burton-Sutton Oil Co. v. Commissioner, supra, p. 32. The substantive test is simple and unqualified. If a taxpayer transfers operating rights solely in consideration of payments geared to extraction and dependent upon extraction, he has retained his "economic interest" and receives the payments as depletable ordinary income.

Five Courts of Appeals have specifically applied this rule where operating rights in hard minerals were transferred solely in consideration of payments per unit, when and as extracted and removed. They have expressly recognized that the Supreme Court's "economic interest" concept is fully applicable to such situations. And their decisions are squarely supported by the Supreme Court's ruling in Bankers Coal Co. v. Burnet, supra. Accordingly, the District Court correctly ruled in the instant case that taxpayer retained his "economic interest" and received the per ton royalties as depletable ordinary income.

Taxpayer invokes (Br. 13-19) appellate decisions in six Circuits, including the Ninth, but -- apart from Linehan, discussed

above -- the cases cited do not support him.

It is not quite clear why taxpayer cites this Court's decision in Gowans v. Commissioner, 246 F. 2d 448, since he acknowledges (Br. 16) that that case involved "a somewhat unique set of facts" and that this Court emphasized exclusive dependence on production income as the test of a continuing "economic interest". In fact, Gowans is wholly inapposite. There the transferee of operating rights had both the right and the obligation to remove a specific total quantity of sand from a designated deposit, during a fixed period, in consideration of a fixed total price, payable in any event. While the total purchase price was prorated over the period of extraction in payments measured by quantity, it was independent of extraction not only in the operating company's ultimate obligation to pay the whole amount but in the securing of this obligation by the company's bank note for the total sum. On these facts, this Court held that the parties effected a capital transaction, i. e., the outright sale of a specific asset for a fixed price.

In the case at bar, by contrast, Star Rock Products was not obligated to remove or pay for any particular amount of materials, but only to pay three cents per ton extracted. On similar facts, the Second Circuit held in Royalton Stone Corp. v. Commissioner, supra, that the transaction was a mere licensing arrangement, emphasizing inter alia that (379 F. 2d at p. 300) --

> No fixed purchase price was paid or payable at any time. If there was no quarrying the taxpayers would receive nothing. The only obligation of the corporations was to pay 20 cents a ton for whatever amount they removed.

Taxpayer cites (Br. 11-12) Barker v. Commissioner, 250 F.2d 195 (C.A. 2d), and United States v. White, 311 F.2d 399 (C.A. 10th), as authority for the proposition that the "economic interest" test is not applicable in sand and gravel cases. But the Second Circuit's decision in Royalton Stone, which directly supports the District Court's decision in the instant case, has restricted Barker to situations where (as in Gowans) there was an obligation to pay a fixed total price without regard to the amount of minerals extracted. Moreover, in Royalton Stone the Second Circuit recognized the applicability of the "economic interest" concept, quoting examples of its application from the Supreme Court's opinion in Burton-Sutton Oil Co.

In White the Tenth Circuit held only that a large lump sum down payment was capital gain. As to future royalties, the court said (311 F.2d at p. 402): "We do not reach the question of whether the payments to be made from production amount to the reservation of an economic interest which would require a different tax treatment of the income from that source". If anything, this indicates a recognition that the "economic interest" concept would control the reserved question as to whether the royalties would be depletable ordinary income or capital gain.

Taxpayer's reliance (Br. 14) on Crowell Land & Min. Corp. v. Commissioner, 242 F.2d 864 (C.A. 5th), is similarly misplaced. The law of the Fifth Circuit today is Wood v. United States, supra, which squarely supports the instant decision, as noted above. And taxpayer errs in contending (Br. 14-15) that Wood approved the

emphasis in Crowell upon the wording of the governing instrument as one of sale. To the contrary, in comparing Crowell with Albritton v. Commissioner, 248 F. 2d 49, the court said in Wood (377 F. 2d at p. 311, fn. 26) that "if the two cases were decided differently solely because of the wording of the agreements, we do not view such distinction as properly determinative of tax consequences under the economic interest test". Wood also disapproved of Crowell to the extent that it based capital gains treatment on the fact that the royalties involved were fixed payments per ton of minerals removed.

Finally, taxpayer cites (Br. 15-16) the Eighth Circuit's decision in Commissioner v. Remer, 260 F. 2d 337 -- but acknowledges (Br. 16) that Remer has been limited to its facts by the same court in Rabiner v. Bacon, supra. Rabiner squarely supports the instant decision in reasoning and result.

In sum, the Second, Third, Fifth, Seventh and Eighth Circuits are now united in holding that a transfer of operating rights in hard minerals, in consideration of payments per unit, when and as extracted, is not a sale; that the transferor retains his "economic interest" and receives the per unit payments as depletable ordinary income. This conclusion is in accord with the relevant decisions of the Supreme Court.

Without more, we submit that the decision in the instant case is correct and should be affirmed.

II

IF THE ROYALTY PAYMENTS WERE THE PROCEEDS OF A CAPITAL TRANSACTION, THEY ARE TAXABLE AS SHORT-TERM CAPITAL GAIN

Section 1222 of the 1954 Code, supra, defines a short-term capital gain as a "gain from the sale or exchange of a capital asset held for not more than 6 months, if and to the extent such gain is taken into account in computing gross income". The "Assignment" to Star Rock Products of the interests of taxpayer and Rodeffer, as co-lessees, was executed on July 9, 1955. (I-R. 134.) The co-lessees' interests were created by the lease dated June 1, 1955, executed on June 17, 1955. (I-R. 133.) Assuming arguendo that the assignment effected a sale of taxpayer's interest, it is obvious that he had not held it for six months; hence the gain from the sale was short-term capital gain.

Taxpayer attempts to escape this conclusion by arguing (Br. 20-22) that the lease of June 1, 1955, merely continued his interest under the lease of December 7, 1954, and that the execution of the new lease should be disregarded for the purpose of determining his holding period. But his interest under the second lease was not the same as under the first. Under the first lease he had the exclusive right to exploit the minerals; he relinquished that right by voluntary cancellation and, under the new lease, shared with Rodeffer the rights to exploit the minerals. The District Court correctly ruled that (I-R. 135): "The voluntary cancellation of the lease dated December 7, 1955, constituted a complete termination

of Fred W. Alkire's leasehold interest in said lease," and that (I-R. 135-136): "The lease dated June 1, 1955, created for * * * Fred W. Alkire, a new leasehold interest which was voluntarily and lawfully assigned to Star Rock Products, Inc." 2/

CONCLUSION

For the reasons stated above, the decision of the District Court was correct and should be affirmed.

Respectfully submitted,

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JANUARY, 1968.

2/ Metropolitan Building Co. v. Commissioner, 282 F.2d 592 (C.A. 9th, 1960), and Miller v. Commissioner, 48 T.C. 649 (1967) cited by taxpayer (Br. 22), present very different factual situations, and consequently are not relevant to the decision of the present case. In those cases the taxpayers received a lump sum as consideration for the complete termination of their interest in leasehold property. Those cases involved the nature of the lump sum payment received for the cancellation of a lease, whereas the problem in the present case is to determine what was transferred.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

/s/ Arthur M. Greenwald
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